wealth preservation
inheritance tax planning

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Prior to 9 October 2007, the inheritance tax (IHT) planning situation for married couples (which in this guide also means civil partners) was relatively straightforward.

The problem: If everything was left to the surviving spouse then, on the first death there would be no IHT payable (as a result of spousal exemption). However, there could be a very large IHT bill on the second death since everything above the Nil Rate Band (NRB) of £325,000 (tax year 2009-10) in the estate of the survivor would be subject to tax at 40%.

The solution: This IHT liability could be minimised by making Wills which include a tax-efficient Trust arrangement, which are explained later on in this guide.

Since 9 October 2007, married couples can potentially leave up to twice the individual NRB on the second death (i.e. £650,000 on current figures) without a liability to IHT and so in theory a Will Trust arrangement is not necessary. However, the situation is not as straightforward as it might appear. In particular, it is NOT the case:

- That the survivor of each married couple will have double the ordinary NRB
- That IHT efficient Will planning is no longer necessary. It is essential
- That IHT efficient Wills drawn up before 9 October 2007 should be changed. In many cases they should not be changed unless other circumstances have altered.

So what has really changed?

On the death of the surviving spouse of a married couple on or after 9 October 2007, the IHT impact, which would otherwise occur by the combining of estates at the time of that second death, can now be mitigated by the survivor's Executors making a transfer claim to the tax office. The claim is to transfer the unused NRB from the estate of the first spouse to die.

How will a transfer claim work?

In order to make a transfer claim, the Executors will need to look back and see whether the first spouse used any of their NRB on their death. Only the unused proportion of that NRB can be set against the amount left by the survivor.

Why is the transferable NRB potentially not as useful as it might at first sound?

Making a **transfer claim** is not best practice tax planning. There are potentially serious downsides to not having a more suitable tax efficient arrangement in your Will.

Will Trust arrangements are still potentially very useful for IHT planning and also for other practical reasons. If instead of using a suitable Will Trust arrangement everything is left to the survivor outright then:

- The survivor might enter means tested long term care. Much of their estate may be paid out in care fees. If a Will using a Trust arrangement was in place this could be avoided
- The survivor could remarry or give all the money away and the beneficiaries who the first person ultimately wanted to benefit might get nothing
- The survivor might get into financial difficulty and their creditors might take everything they have. Again, the beneficiaries who the first person ultimately wanted to benefit might get nothing
- If the first spouse to die has any business or agricultural property which is relieved by IHT business property relief or agricultural property relief, then, unless those assets are either given away outright to beneficiaries other than their spouse or into a flexible Discretionary Trust arrangement, the benefit of that type of valuable relief is lost
- If the value of the assets in the estate of the first to die, grows at more than the rate of increase in the NRB (which grows

at the rate of inflation) then IHT may be payable. A Will Trust arrangement takes the growth in the value of the assets out of the equation on the second death.

Other Problems

- If a married couple have over £650,000, utilising the new transfer claim rules will not assist in protecting those additional assets from a liability to IHT
- It should not be assumed that the NRB cannot be frozen; reduced; or scrapped. It is clearly a political instrument and it is therefore vulnerable to change
- Making a transfer application will involve ascertaining the unused NRB of the first to die. Will suitable records exist to include details of joint property transferred at the time of the first death, and details of lifetime gifts which may limit the NRB at the time of the first death? If not, applicants will be at risk of either being unable to make their case to the tax office, or incorrectly stating their case.

Tax Planning through Wills

So, despite the changes made on 9 October 2007, tax efficient Will planning remains appropriate in most cases where the value of joint estates exceeds the basic £325,000 IHT free NRB. Such Wills are known as NRB Discretionary Trust Wills (DTWs). DTWs allow use to be made of the NRB on the first death whilst still permitting the survivor to continue to benefit from, and control, that first estate.

A sum equal to the NRB is left to the Trustees of a Discretionary Trust. The wording of the Trust is flexible enough to permit the sum left to the Trust to be satisfied by a **charge** or **debt** instead of money or assets worth £325,000. If most of the estate is tied up in the marital home the survivor is not left short of money and the marital home does not have to be sold.

As the capital from the first estate has been passed to a Discretionary Trust, it is outside the survivor's estate and is not taxable on the second death. When the survivor dies their own estate will exclude that £325,000 and provided it too is below £325,000 it will be tax free. A transfer claim is not then required.

Are there any disadvantages to DTWs?

Whilst the surviving spouse has some degree of control over the Discretionary Trust Fund, it is not the same as owning the assets outright. A charge or debt scheme may need to be set up which may incur an additional amount of work for the Executors and Trustees.

Preparation for making DTWs

Care must be taken to ensure that the two spouses have roughly equal assets:

- If the joint estate is worth more than double the IHT threshold, it is divided so both spouses own enough individually to fund the £325,000 required in the Discretionary Trust Fund
- If the joint estate is worth less than double the IHT threshold, it is evenly divided so neither spouse owns more than the individual IHT threshold (otherwise if the richer spouse is second to die, unnecessary IHT is payable on the second death).

Couples who jointly own a home may assume they own half each. This is rarely true. In most cases, homes jointly owned are owned under what is called a Joint Tenancy. This means when one spouse dies, the whole property automatically passes to the other, irrespective of any Will and cannot be used to make up any of the £325,000.

Instead, the Joint Tenancy must be split and the Land Registry informed. The property will then be owned as Tenants in Common and so allow each spouse to deal with his or her share in the Will. If the above arrangement does not give each spouse a separate estate of at least £325,000 the exercise needs to be repeated for other joint investments.

What are the different types of DTWs?

There are different ways of putting DTWs into effect which we will discuss with you. They include making use of a charge or debt scheme in order to fund the trust.

If the total assets of a married couple amount to more than £650,000, DTWs can still minimise any IHT on those excess sums. If the Trustees of the Discretionary Trust lend the £325,000 to the survivor, rather than leaving it in the Trust, the Trust then owns the debt. If the survivor decides they do not need the £325,000 which they have received from the Discretionary Trust, that extra £325,000 can be given to the children instead. If the survivor lives for seven years from the date of any such gift then the £325,000 is outside the survivor's estate for IHT purposes, but the loan to the Trust Fund remains outstanding. In these circumstances the same £325,000 has effectively been used to obtain IHT relief twice, reducing the estate's potential IHT liability further.

In addition, if any loan from the Discretionary Trust to the survivor is subject to a market rate of interest then the value of the loan increases over time. For example, if the value of the loan increases from £325,000 to £400,000 because interest is rolled up then £400,000 is deducted from the survivor's assets before determining how much IHT is payable.

If the level of your assets means your beneficiaries will still face an IHT liability then we can discuss further options available to you.

An explanation of the Debt and Charge Schemes

The Debt Scheme

All or part of the Trust Fund is made up by an IOU from the surviving spouse to the Trustees. This is the simpler of the two schemes but your Executors are strongly advised to take advice before using it, as in certain circumstances it may fall foul of Section 103 of the Finance Act 1986 which relates to artifical debts. If there is a risk, the charge scheme is recommended instead, and with changes in HM Revenue & Customs practice the charge scheme is always safer.

The Charge Scheme

Before the Residuary Estate of the deceased spouse is distributed, a charge is placed on their share of the marital home to make up all, or part of, the Trust Fund. A charge operates like a mortgage and is registered at the Land Registry stating the Discretionary Trustees have a monetary interest in the property and that it cannot be sold unless this monetary interest is paid off.

When the surviving spouse dies, the value of their estate is calculated by subtracting the amount of the charge. The NRB Discretionary Trust can be satisfied without having to use actual funds such as bank accounts or other monetary assets.

Issues with the surviving spouse moving home

The reason the charge scheme works without falling foul of the artificial debt provisions, is that the charge is placed on the property within the deceased spouse's Residuary Estate by the Executors and not the surviving spouse. *NB: we strongly recommend the surviving spouse should not be an Executor for the NRB type of Will to avoid any suggestion of an artificial debt.*

The problem: If the surviving spouse wishes to move home, it will be the surviving spouse, and not the Executors, who must impose the charge on the replacement property because a charge may only be placed on a property by somebody who has an interest in it, i.e. as a 100% owner, the surviving spouse. The scheme may now fall foul of the artificial debt provisions.

The solution: If the property remains within

the Residuary Estate of the first to die the problem can be avoided. Upon the sale of the original property, 50% of it remains within the Residuary Estate of the deceased spouse and so the Executors are able to transfer this share to the new property along with the charge. Hence the arrangement cannot fall foul of the artificial debt provisions. All of this is possible by using the NRB with Life Interest Will rather than a NRB with Absolute Interest Will.

The Taxation of Discretionary Trusts

The tax payable in relation to IHT, Capital Gains Tax and Income Tax is explained below.

IHT

Creation: A gift into a Discretionary Trust, if it does not exceed the NRB threshold, is not a chargeable event and no IHT is payable.

Duration: Every 10 years there is an anniversary. At this point, the Trust Fund is valued. Any payments which have been made from the Trust Fund are added to the valuation. Any sum in excess of the then NRB is taxed at 6%. In practice, as the IHT threshold normally increases in line with inflation, there will only be a tax liability if the Trust Fund's value increases above the level of inflation.

Termination: When the Discretionary Trust comes to an end, again the anniversary rules apply.

Capital Gains Tax (CGT)

Creation: Whilst a gift into a Discretionary Trust can give rise to a liability, this is unusual upon creation of a Discretionary Trust in a Will. In any event, the liability is usually passed onto the Trustees and deferred until they make a disposal.

Duration: The Trustees are liable to pay CGT if any part of the Trust Fund is disposed of at a profit, together with any of the deferred liability. The current rate is 18%. The Trustees have an annual CGT allowance which is half that applicable to an individual.

Termination: When a beneficiary becomes entitled to any portion of the Trust Fund, there is a deemed disposal by the Trustees for CGT purposes. The payment of tax may be deferred by way of a hold-over election into the hands of a UK resident beneficiary so that any tax charge will only be made when they dispose of the asset received. It is relatively easy for your Discretionary Trustees to minimise CGT on the Discretionary Trust altogether.

Income Tax

Creation: There is no Income Tax liability upon creation of a Discretionary Trust in a Will.

Duration: This type of Trust effectively pays tax at 40%. Beneficiaries who are basic rate tax payers may be able to reclaim some of the Income Tax paid by the Trust. The tax would then be no more than the beneficiaries would pay if you had given the NRB legacy directly to them.

Termination: On the termination of a Discretionary Trust, the Trustees cease to be liable for any further Income Tax. The assets and the income produced by them now belong to the ultimate beneficiaries.

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